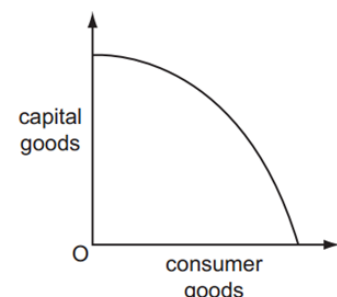


- 4 In December 2012, the Federal Reserve announced that it will keep interest rates suppressed as long as it does not achieve its unemployment target rate of 6.5%.
- (a) Explain why high unemployment is undesirable for an economy. [10]
- (b) Discuss the view that interest-rate centred monetary policy is, more often than not, the best option to achieve the macroeconomic objectives of a government. [15]

**(a) Explain why high unemployment is undesirable for an economy. [10]**

Explain concept of unemployment.

- Define unemployment: arises when people who are willing and able to work are unable to be gainfully employed
  - The unemployment rate of an economy is the proportion of the labour force that is unemployed.
  - Unemployment rate =  $\text{no. of unemployed workers} / \text{labour force} \times 100\%$ , where the labour force refers to those who are employed and unemployed but are actively seeking work.
1. Explain high unemployment
    - While unemployment rates of an economy are typically never at 0%, an economy seeks to attain low unemployment. Even countries considered to be at full employment still have a positive, but low unemployment rate.
    - High unemployment on the other hand occurs if the economy is experiencing unemployment levels significantly higher than its full employment rate of unemployment.
    - Examples: Spain (25.6% in 2014), United States (8% in 2012)
    - When this happens, the economy has a **sizeable** proportion of the workforce that are willing to work but are without job.
    - This is undesirable both from an economic and social point of view.
  2. Explain economic costs of unemployment: output loss
    - Unemployed constitute a valuable part of labour force → could be used to produce something valuable for society
    - But without gainful employment the unemployed are unable to contribute to the production of goods and services society needs and wants.
    - In terms of the PPC (ref to PPC diag.), the economy could have been producing higher levels of output at point A if all its resources are fully and efficiently utilised. But because resources such as labour are not fully employed, it is instead producing within the PPC at point B, which enjoys less amounts of capital and consumer goods.
    - → lower output
    - (Furthermore, **high and persistent cyclical unemployment** can translate into more stubborn structural unemployment when workers who remain unemployed over a long time lost their skills and employability → harder to lower this kind of unemployment by simply creating demand. In long run, these workers might turn discouraged and leave the workforce → lowering productive capacity)
    - **The higher the unemployment, the more the output loss.**



3. Explain economic costs of unemployment: revenue loss to the government, extra expenditure
  - Government collects tax revenue for a variety of purposes, including funnelling funds into improvements in infrastructure, transfer payments, and its operations.
  - When there is higher unemployment → more people are not earning an income → tax base shrinks → government receives less income tax  
(at the same time, higher unemployment usually also occurs together with falling income levels → people pay less income tax → fall in tax revenue)
  - Unemployed cut down on income-induced spending on goods and services ( $C = a + bY_d$ ) → government tax revenue collected on goods and services consumed (VAT/GST) falls.
  - (For countries with unemployment benefits like UK, US) Higher unemployment → more number of people receiving unemployment benefits → government expenditure rises
  - The **higher the unemployment, the more likely the government budget will move into a worsened position**
  - The loss in tax revenue and the possible increase in expenditure means that governments might have to choose to sacrifice certain areas of expenditure thus incurring opportunity costs.
  
4. Explain economic/social costs of high unemployment: lower standard of living
  - With the output loss from having labour resources unemployed → lower material SOL
  - With worsened government budget position, the government might have to compromise spending on certain merit goods like healthcare and education that lower non-material and material SOL
  - Furthermore economies with high unemployment rates are typically found to have a higher incidence of theft, robbery, alcoholism, depression, etc → lower non-material standard of living. Also, this causes social and political instability → lower investor confidence → further affecting economic growth and employment levels

Other possible points: worsened income inequality in society

LORMS:

Level	Descriptors	Marks
3	For a well-developed explanation of at least 3 negative consequences of HIGH unemployment in an economy, well-supported with relevant examples.	9-11
2	For an under-developed answer of some consequences of unemployment in an economy.	6-8
1	Smattering of points about the negative consequences of unemployment in an economy. Conceptual errors present.	1-5

- (b) Discuss the view that interest-rate centred monetary policy is, more often than not, the best option to achieve the macroeconomic objectives of a government. [15]

<ul style="list-style-type: none"> <li>Interest-rate centred monetary policy – manipulation of interest rate as a tool to controlling money supply and the level of consumption and investment and thus AD in the economy</li> <li>Macroeconomic objectives – high and sustainable economic growth, low inflation rate, low unemployment, healthy BOP.</li> <li>Explain transmission mechanism: expansionary monetary policy → lower interest rates using open market operations to increase money supply → lower cost of borrowing to firms → increase expected profitability of lower-end investments → increase in interest-sensitive investments. At the same time, lower cost of borrowing to consumers → cheaper cost of credit → increased consumption on big-ticket consumer items that require borrowing to finance. Overall, the increase in C and I → higher AD</li> </ul>		
Economic Objective	<i><b>T: Interest-rate centred monetary policy is a better way to achieve macroeconomic objectives</b></i>	<i><b>AT: There are other better ways of achieving the macroeconomic objectives of the government</b></i>
Economic Growth	<p>E.g. for a country (e.g. US) experiencing recession and high unemployment that would like to increase economic growth and lower unemployment</p> <ul style="list-style-type: none"> <li>Use expansionary monetary policy → higher AD → help to boost economic growth and lower cyclical unemployment through the multiplier effect.</li> </ul>	<p>Supply side policy should be used for countries which want to pursue sustainable economic growth in the LR, in order to match increases in AD with corresponding capacity upgrades. <i>Explain appropriate SS-side policy.</i></p>
Low Unemployment	<p>Better because...</p> <ul style="list-style-type: none"> <li>Affects both consumers and firms' expenditure</li> <li>Good especially for countries with large fiscal deficits (which makes fiscal expansion difficult) like UK</li> </ul> <p>Limited because...</p> <ul style="list-style-type: none"> <li>For countries with already very low interest rates (e.g. Japan, US) they are facing the liquidity trap → unable to further lower interest rates (unless they make it negative) to stimulate AD</li> <li>Depends on the effectiveness of the transmission mechanism – whether banks are willing to lend and firms and consumers willing to borrow, since these are inherently risky ventures. During downturns, esp the recent financial crisis in the US, the transmission mechanism can break down due to banks hoarding cash instead of loaning it out → limited use in stimulating C &amp; I &amp; AD</li> </ul>	<p>Expansionary monetary policy is better to lower cyclical unemployment, but is not the best in the case of structural unemployment. In that case, supply side policy that facilitates retraining and skill-upgrading of workers is a better option.</p>

Low Inflation	<p>For countries facing high inflationary pressure e.g. China:</p> <ul style="list-style-type: none"> <li>• Use contractionary monetary policy → lower <math>i/r</math> → lower AD → economy near full capacity will cool down competition for limited resources left → lower demand-pull inflation</li> </ul> <p>Better because...</p> <ul style="list-style-type: none"> <li>• Increasing interest rates work on cooling off first the high-valued investment and consumption as these are the ones likely to be dependent on financing and will be more interest-sensitive. Since these are also high-valued → have an emphasised impact on AD</li> </ul> <p>Limited because...</p> <ul style="list-style-type: none"> <li>• During times of high confidence (e.g. in China in 2000's), investors might continue making investment decisions not so much based on interest rates but based on animal spirits(herd sentiment) which limits the extent AD falls by</li> <li>• Compromises economic growth as AD cools, hurts economy and SOL</li> </ul>	<p>Explain some other policy that might be better at achieving low inflation.</p> <p>Raising productive capacity might be better at times where inflation is caused by demand-pull factors → explain SS-side policy</p> <p>Appreciation of currency could be a better policy than interest-rate centered monetary policy because:</p> <ol style="list-style-type: none"> <li>1. Inflation could be imported cost-push in nature (e.g. oil price spikes)</li> <li>2. Lack of control of interest rates but there is control over exchange rates</li> </ol>
Healthy BOP	<p>For a country with current account deficits:</p> <ul style="list-style-type: none"> <li>• Use contractionary monetary policy → lower <math>i/r</math> → lower AD → economy near full capacity will cool down competition for limited resources left → lower demand-pull inflation → cheaper exports → boost export competitiveness → assuming <math>PED_x &gt; 1</math>, increases X revenue. At the same time, lower AD → lower economic growth → lower demand for imports. Overall, BOT improves.</li> </ul> <p>Limited because...</p> <ul style="list-style-type: none"> <li>• Compromises economic growth as AD cools, hurts economy and SOL</li> </ul>	<p>For a country that encounters BOP deficits which are not due to its BOT deficit or because of structural problems, then interest-rate centered monetary policy might not be the best option.</p> <p>Instead then, supply-side policies to develop new areas with potential comparative advantage should be used → explain such policies.</p>
General	<p>Limited ability to use interest rates:</p> <ul style="list-style-type: none"> <li>• Countries like Singapore which is very open to capital flow and chooses to manage exchange rates → unable to control interest rates and is interest-rate taker</li> </ul> <p>Countries such as PIGS (Portugal, Italy, Greece and Spain) who are bound by the economic union to ECB interest rates</p>	

Level	Descriptors	Marks
3	For a balanced answer supported with well-developed economic analysis on whether interest-rate centred monetary policy is the best policy for governments to achieve the macroeconomic objectives. Answer shows consideration of various macroeconomic objectives and different countries' governments. Policy alternatives are also discussed.	9-11
2	For an under-developed answer or a one-sided discussion on whether interest-rate centred monetary policy is the best policy for governments to achieve the macroeconomic objectives.	6-8
1	Smattering of points about interest-rate centred monetary policy and its use in achieving macroeconomic objectives of the government. Conceptual errors present.	1-5

Level	Descriptors	Marks
2	For insightful evaluative comment well-substantiated by economic analysis and judgement.	3-4
1	For unsubstantiated evaluative comment.	1-2